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A Leveraged Buyout of Paychex, Inc.

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Finance Honors Project

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Leverage Buyout Overview

A leveraged buyout is the acquisition of a company funded primarily through debt, typically 60% to 70% of the price, while a financial sponsor provides the remaining amount of funding. A public company is acquired, then made private, and finally sold after a period of time for a profit. During the time that the company is held private, cash flows of the firm are used to repay the debt taken on to acquire it and actions are taken to improve the business and performance of the firm (Rosenbaum 161-162).

The main way in which the success of a leveraged buyout is evaluated is through the internal rate of return, which measures the total return on the sponsor's equity investment. The benchmark return usually expected is 20%. The factors that most heavily influence this are the projected financial performance, purchase price, and financing structure of the deal (Rosenbaum 171-172).

Returns can be generated through debt repayment or enterprise value growth, but in this proposed acquisition, it will be done through debt repayment. If a company is purchased for $1 million and 50% is financed though debt and the other 50% is financed through an equity contribution, as that debt is reduced the equity portion is increased proportionally. If it is sold for the same amount it was purchased for, but the debt has been reduced to $100,000, the equity portion would then total $900,000. The investment of $500,000 would have increased to a value of $900,000, giving a substantial return to financial sponsors.

When choosing a firm for a potential leveraged buyout there are many factors to consider. One of the most important is selecting a firm with little to no debt, since after the company is taken private it will be highly leveraged. Another important consideration is the cash flows and asset base of the company. Realizing a return on the investment for financial sponsors is dependent upon paying down the debt used to purchase the company. To do so, said company needs stable, large, and predictable cash flows to pay yearly interest payments and reduce the size of the debt over time. A substantial asset base is also ideal as it can provide collateral to pay off the principal of loans if bankruptcy were to occur (Rosenbaum 161-162).

Paychex, Inc. was chosen as an ideal leveraged buyout candidate, because it matched many of the above-mentioned criteria. The company has a current total asset base of $6,440.9 million and free cash flows of $576.6+ million over the last five years. On top of meeting those two very important criteria, the company also had no debt and a market capitalization of $20,873.4 million. They have enough funds from assets and free cash flows to support large debt repayments, they have no debt allowing them the ability to become highly leveraged, and their high market capitalization coupled with their large market share within the industry made them ideal for potential growth.

Company Overview

Paychex, Inc. was established in 1979 in the state of Delaware. They provide services related to payroll, human resources, insurance, and retirement to small and medium sized businesses. They currently serve more than 605,000 payroll clients in both the United States and Germany. Their mission is to be the leading provider within their industry and sector by focusing on flexible and convenient service, advanced technology, and comprehensive service offerings (PAYX 2016 Annual Report 2).

Their main product is called Paychex Flex, which is a cloud-based platform that contains a multitude of solutions that cover recruiting, payroll, employee benefits, retirement services, etc. Clients have the ability to customize their services based on their unique needs through product bundles. This coupled with a dedicated service center and mobile application allow them to provide convenience and flexibility to their clients (PAYX 2016 Annual Report 2-3).

Payroll processing is the primary service provided by Paychex, Inc. which involves the calculation, preparation, and delivery of payroll checks. Payroll tax administration, employee payment, and regulatory compliance services are also included (PAYX 2016 Annual Report 3-4).

The human resource service offers comprehensive human resource outsourcing solutions, retirement administration consisting of plan implementation and ongoing maintenance, cloud-based employee benefit management, and insurance services including property and casualty coverage (PAYX 2016 Annual Report 4-5).

The accounting and financial service includes a cloud-based accounting service, payment processing, payment distribution, and a loan resource center (PAYX 2016 Annual Report 5).

Interaction with small-business clients is focused on reducing the complexity and risks associated with running their own payroll. Simplification is achieved through their core payroll processing platform known as Paychex Flex that offers the processing itself, online access for employees, general ledger services for accounting purposes, and access to their web-based report center. There is also a focus on helping clients with scheduling, tracking and reporting of time worked, and complying with overtime regulations (PAYX 2016 Annual Report 3).

The mid-sized business clients are given the opportunity to customize their services more based on the size and complexity of their payroll needs with the Paychex Flex Enterprise solution set. They are offered a SaaS solution that combines their main payroll processing service with human resource management, employee benefits administrations, and time and labor management (PAYX 2016 Annual Report 3).

Industry Overview

Within the geographical area that Paychex, Inc. operates, there are eleven million businesses in need of payroll processing and human resources services. Of those eleven million businesses, 99% have fewer than one hundred employees which is the target market of the company. Their focus is in this specific size range due to the large potential client base and the projection that demand for the services they provide is moving to smaller businesses (PAYX 2016 Annual Report 6).

The main risks that are faced by both the industry and Paychex, Inc. are those related to government regulations and cyber security. Changes in regulations could affect the number of benefits employers must provide and in turn decrease or eliminate some of the services provided by payroll processing and human resource companies. Due to the fact almost all the services provided by these types of companies are done so through networks and cloud-based platforms any kind of security attack could have a huge impact on the ability for them to do business (PAYX 2016 Annual Report 8-10).

The industry does not face any real seasonality risks or advantages, but there is often an increase in clients and revenue due to businesses paying year-end bonusing and having a need for other year-end services (PAYX 2016 Annual Report 7).

Although the market is highly competitive, they only face one primary national competitor. There are obviously other regional and local providers, but they do not have close to as many clients as Paychex, Inc. Competitive advantages are based on service responsiveness, ease of use of technology, breadth of service offerings, and price. The company feels their focus on advanced technology, mobile applications, and outstanding customer services gives them a competitive advantage (PAYX 2016 Annual Report 6-7).

Performance

Paychex, Inc. has demonstrated steady growth in 2016. Both total revenue and service revenue increased by 8% to $3 billion and $2.9 billion respectively, mainly due to a high retention and growth of clients from 590,000 to 605,000 (PAYX 2016 Annual Report 15-16).

Net income increased 9% to $756.8 million, diluted earnings per share increased 10% to $2.09 per share, and $606.5 million in dividends were paid to shareholders. This was mainly achieved through the ability to increase each service provided from 6% to 10% while maintaining no debt (PAYX 2016 Annual Report 16).

Looking at the stock performance. assuming and investment of $100 and reinvestment of dividends, over the last five years compared to both the S&P 500 and their peer group shows (PAYX 2016 Annual Report 13):

- Paychex, Inc. – 101.67% return
- Peer Group – 108.71% return
- S&P 500 – 73.25% return

As a whole, the financial performance of the company in recent years have shown a steady growth benefiting both the operations of the firm as well as the stock price of the firm.

Outlook

In 2017, Paychex, Inc. is expected to continue steady growth based on current economic, market, and interest rate factors remaining the same. Payroll service revenue is expected to grow 4%, HRS revenue is expected to grow anywhere from 12% to 14%, total service revenue is expected to grow 7% to 8%, net income is expected to grow 8%, and operating income as a percentage of service revenue is expected to grow 38% (PAYX 2016 Annual Report 17-18).

Leveraged Buyout Strategy

The first step in the leveraged buyout was determining an appropriate offer price through various methods of valuation.

The first method involved using an analysis of how comparable companies would be valued. I chose the companies of Automatic Data Processing Inc, Intuit Inc, and Equifax Inc all of which are involved in some form of transaction processing or human resource solution for businesses.

The second method I used was a discounted cash flow model. This involved discounting the predicted future cash flows of Paychex, Inc. to determine the intrinsic value of the firm.

The third and final method I used involved analyzing precedent transactions of companies similar to Paychex, Inc. in size, industry, and business operations and what kind of premiums were paid in those acquisitions. I chose an acquisition of Probusiness Service Inc by General Atlantic LLC that took place in 2000, an acquisition of Bottomline Technologies de Inc by General Atlantic LLC that took place in 2003, and an acquisition of Nuance Communications Inc by Morgan Stanley.

I chose to use the results of the precedent transactions method in determining the offer price of Paychex, Inc, because I think it is the most realistic form of valuation since the information is based off transactions that actually took place. This means that multiples and premiums paid are not hypothetical, but based in reality. For the transactions that were chosen, the premium paid on the stock price thirty days prior to the deal ranged from 10.3% to 22.2%.

The current stock price of Paychex, Inc. is $56.20 per share and in this proposed deal $67.44 will be offered to current shareholders, which is a premium of 20%. Paying that price for the 361.7 outstanding shares, plus other fees and expenses results in a total purchase price of $24,738.2 million.

1.4% of the deal will be funded with $352.1 million in cash on hand, 32.6% will be funded with investors' contributions of $8,069.3 million, and the remaining 66% will be funded with $16,316.8 million in debt. Of the 66% funded through debt, $7,658.4 million will be provided through a ten year, Term Loan B Facility with a LIBOR floor of 1.25% and spread of 2%. The remaining $8,658.4 million of the debt will be financed through senior notes with a term of ten years and a coupon of 3.25%. Ultimately, Paychex, Inc. will go from have no debt to being a company comprised of 34% equity and 66% debt.

Going into the deal, Paychex, Inc. has an EBITDA multiple of 20.5x. The strategy of this acquisition is to slowly decrease the size of the debt and in turn increase the size of investors' equity, so the planned exit EBITDA multiple will remain 20.5x. The exit will occur five years after the purchase of the company.

During the time in between purchasing and selling the company, Paychex, Inc. is expected to see steady growth. Assumptions about sales growth, cost of goods sold, days sales outstanding, etc. were based on historical performance as well as projections made by the company while taking into consideration improvements that can be made through taking the company private.

Based on the proposed purchase price, financing structure of the deal, assumptions about the future of the company, and entry/exit multiples, investors will see a 29.6% return on their investments. Their initial contribution of $8,069.3 million will be worth $29,517 million.

Current Shareholders' Considerations

This deal is favorable for current shareholders of Paychex, Inc. as they will receive a 20% premium on the current stock price of the firm. We determined this price to be appropriate for various reasons. The first being that it was in line with the premium paid in previous acquisitions of similar companies. The precedent transactions analysis showed a premium paid ranging from 10.2% to 22.2%. That coupled with the fact that Paychex, Inc. has shown a steady increase in value and stock price over the last ten years led the premium to be in line with the higher range of those paid. If the proposed deal takes place, the current shareholders will be appropriately compensated for their stake in the company.

Investors' Considerations

The first important consideration of this deal is the valuation of Paychex, Inc. The company is an ideal investment because it is has the components necessary to withstand a leveraged buyout, it has experienced steady growth and is expected to continue that trend, and it has a large market share in its industry.

The strategy of the acquisition is to pay down the debt over the time the company is held private and in turn increase the value of investor's equity. With this proposed strategy, investors are expected to make a 29.6% return after the five-year exit. If there were a situation in which the company would not be able to be sold in that period, the lowest return investors could expect is 21.5% after ten years. This is assuming reasonable growth for the company based off past performance. This is a very modest scenario, because it assumes that no improvements will be made resulting in the ability to sell the firm at a higher EBITDA multiple.

It is more likely that the company will be sold at a higher multiple as there are improvements that can be made. Some include better integration of all the services offered through Paychex, Inc., continued improvement in accessibility of mobile applications and cloud-based services, and an expansion of services into fields like financial advising. These factors will not only allow the company to maintain their clients, but expand that client base and in turn accelerate the growth of the company. If these changes were to result in a reasonable EBITDA multiple of 22x, investors could expect a 32.4% return after the five-year exit.

There is always a chance of the economic and financial environments not being favorable in the next five years, which is why the analysis of this proposed deal evaluates probable, upside, and downside situations. In a downside situation in which growth is not as high as expected, costs are higher, etc. investors would still see a 22.1% return after five years. Although it is important to plan for the possibility of downside situations, they are not highly anticipated and none of them result in investors losing money.

Bond Holders' Considerations

The major consideration for potential lenders for the acquisition of Paychex, Inc. is the ability for the company and owners to pay back the money. The two main reasons Paychex, Inc. is an ideal company are the large asset base and steady cash flows it has.

As of right now, Paychex, Inc. is a no debt firm with an asset base of $6,440.9 million and free cash flows of $576.6+ million over the last five years. These factors are important because they demonstrate the ability of the company to become highly leveraged, pay annual interest and coupon payments, and ensure payment to bondholders if they were to go bankrupt. The performance of the company over the last five years coupled with expected steady growth should also be taken into consideration.

The proposed debt schedule will involve a Term Loan B Facility totaling $7,658.4 million that will be paid down over ten years. The remaining $8,658.4 million of the debt will be financed through ten year senior notes. Projections of the company after acquisition demonstrate the ability to pay off mandatory coupon and interest payments as well as having extra cash flows to make optional payments.

Summary

In summary, Paychex, Inc. is the proposed target for this leveraged buyout. It is a company with steady free cash flows, a large asset base, and historical steady growth making it the ideal candidate.

The proposed deal will involve 66% financing through various forms of debt and 34% financing through a mixture of cash on hand and investors' contributions. A 20% premium will be paid to current shareholders on the stock price of the company. The entry EBITDA multiple is 20.5x and the proposed valuation shows the multiple remaining the same at exit. Through paying down the debt and making improveents over the five-year term in which the company will be held private, investors can expect to see a 29.6% return. All parties involved can expect to receive appropriate compensation for the risk taken on in going through with this proposed leveraged buyout of Paychex, Inc.

Sources

"PAYX 2016 Annual Report." *E R O* (n.d.): n. pag. *www.investor.paychex.com*. Web. 2 December 2016.

Rosenbaum, Joshua, and Joshua Pearl. *Investment Banking: Valuation, Leveraged Buyouts, and Mergers & Acquisitions*. Hoboken, NJ: John Wiley & Sons, 2009. Print.

Attachments

LBO Analysis

Comparable Companies Analysis

Discounted Cash Flow Analysis

Precedent Transactions Analysis